
INTERNATIONAL BANKING**I. INTRODUCTION**

The last few decades have witnessed significant growth in international trade, increased commercial multinationalism, and growing interdependence of national economies. This trend has increased the demand for international financial services worldwide. The number of U.S. banks significantly involved in international finance is relatively small, but major banks have expanded both the volume and scope of their international operations and more small banks are providing international banking services. Since the 1960's, the U.S. banking system has greatly expanded its international role and it now is a significant activity for an increased number of banks. It has, therefore, become increasingly important that the examiner understand and review international activities when analyzing a bank's overall condition.

The international operation of a bank is usually conducted in a separate division or department even though many of the activities parallel those performed elsewhere in the bank. Large banks typically operate an international division which may include a network of foreign branches, subsidiaries and affiliates. Smaller banks, or those with limited international activity, often utilize only a separate department in conjunction with a network of foreign correspondent banks. In either case, the international section will usually have its own management and staff as well as distinct accounting systems and controls.

Examination Objectives

The objectives of examining an international department are basically the same as those of examining other areas of the bank. However, some modification of examination techniques and procedures may be required because of the specialized nature of international banking. Documentation and accounting procedures for international operations may differ from domestic banking and the department may operate under separate laws and regulations.

The examination of the international department is usually conducted concurrently with the commercial examination of the bank. Preexamination planning should be used to

determine the scope of the examination and personnel requirements. A good starting point is to review a bank's most recent Uniform Bank Performance Report (UBPR), Reports of Condition and examination reports. These reports will indicate the existence of an international department, foreign branches or subsidiaries, the volume of international activity, and some indication of the nature of the bank's international business.

The examination can usually be conducted at the bank's head office or some other centralized location. Banks that operate foreign branches or subsidiaries usually maintain sufficient duplicate records at home offices to permit a centralized international examination. In fact, Part 347 of the FDIC's Rules and Regulations imposes minimum recordkeeping standards upon state nonmember banks that operate foreign branches or subsidiaries. These standards require that a bank maintain at its head office duplicate records of offshore operations which will permit a centralized review of asset quality, funding operations, contingent liabilities, and internal controls. In most cases it is expected that this duplicate information will be adequate for examination purposes. However, on-site examinations of foreign branches will be necessary in some cases because of inadequate information at the head office, or unusual features concerning the activities of the branch. Overseas examinations should be planned very carefully in order to effectively use personnel. It is important that the international examiner determine the availability and quality of information maintained at the head office before commencing a foreign branch examination. To do this it may be advisable to conduct a pre-examination visitation or begin the foreign branch examination after commencing the domestic examination. Examiners will find many similarities between a bank's international and domestic operations. For example, a bank will extend credit, maintain cash and collection items, maintain foreign and domestic correspondent bank accounts, accept and place time deposits, maintain customer deposit accounts, and borrow funds both domestically and internationally. Other activities are unique to international banking. Among these are issuing and confirming letters of credit, creating acceptances, and trading in foreign exchange. Another element of international operations not found in domestic banking is

country risk. This refers to the political, economic and social conditions of countries in which a bank has exposure and it must be taken into consideration when evaluating a bank's international operation.

International banking is a dynamic field which embraces a wide spectrum of financial services and practices. This section of the manual is not intended to provide exhaustive coverage of the subject; rather, the discussion is limited to the basic functional areas of international banking. Many of the activities of an international department parallel those conducted in other areas of the bank. In these instances treatment of the topic is limited largely to those features pertinent to international banking. For this reason the examiner will find it useful and necessary to refer to other areas of the manual. Also, there are a number of laws, regulations and Corporation policy statements which deal wholly or in part with international banking. These are discussed throughout the text of this section and several are reviewed under a separate heading. Examiners should be familiar with these laws and will find it necessary to refer to them for a full understanding of their content and applicability.

II. INTERNATIONAL LENDING

Bank Activity

Banks engaged in international lending are both geographically concentrated and numerically limited. A large percentage of international credits originate at New York city institutions, with most of the remainder negotiated in secondary money- market centers including Chicago, Miami and San Francisco. Only about 750 of the over 14,000 U.S. commercial banks have organized a formal international department, and a much smaller number have established overseas branches or domestic Edge Act corporations outside their home state. However, among those banks that have made a substantive commitment to international activity, international loans have increased considerably in size, complexity and geographical scope in recent years. Such loans are variously extended to foreign governments, foreign banks, foreign companies, multinational corporations, and U.S. importers and exporters.

Profitability

A bank's major source of profit, both internationally and domestically, is interest received from the extension of credit. Other international department activities, such as cable and foreign exchange operations, are necessary adjuncts to international banking and part of the capability to service correspondent relationships. However, few of these activities produce net income after expenses, and if these were the only services of international banking, few banks would be attracted to the field. As a nation rich in capital, the United States makes its greatest contribution to international finance by providing credit facilities to stimulate trade and development around the world. In so doing, a number of major U.S. banks have also found an area of great potential profit.

International Risk

When a bank extends credit, either domestically or internationally, it contemplates the riskless rental of money. Obviously few bank loans are completely without risk and bank lending officers must assess the degree of risk in each application. Foreign loans share most of the same characteristics of domestic credits plus several other risk criteria unique to international lending. For convenience, these criteria are considered under three categories; financial (credit) risk, currency (foreign exchange) risk, and country risk.

Financial Risk refers to the potential economic inability of a borrower to comply with contractual credit terms and bears the closest resemblance to domestic lending. Evaluation of the risk is similar to any credit decision and involves analysis of appropriate factual information including credit volume requested, loan purpose, anticipated term and proposed repayment source. Additionally, standard credit file information such as financial statements covering several years and the borrower's performance history on previous loans would be reviewed. The added difference in international lending is that applicable information is less readily available and less detailed. Foreign financial statements are frequently unaudited and their format varies from country to country. Moreover, although banks around the world regularly share information with

each other on a confidential basis, there are often barriers to acquiring such information from foreign sources. Thus, in the financial evaluation of international loans, the credit decision must frequently be based on information inferior to that available in domestic applications.

Currency Risk pertains to the vulnerability of international lenders to variations in rates of currency exchange, and in every international extension of credit someone has a currency conversion exposure. U.S. banks attempt to restrict the risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited. If a dollar loan is utilized in a foreign borrower's own country, it will be necessary to convert the proceeds into local currency. Subsequently, when the loan matures, U.S. dollars will be required for repayment. The problem then arises that even though the borrower may have sufficient local currency, the country may not have the dollars available to sell, thus the borrower would be at the mercy of the country's central bank and might not be able to make dollar remittance.

Country Risk is the primary factor that differentiates international lending from domestic lending. In broad terms, country risk encompasses an entire spectrum of risks arising from economic, social, legal and political conditions of a foreign country that may result in favorable or unfavorable consequences for borrowers in that country. Specifically, country risk analysis includes assessment of the likelihood of political or social upheaval, nationalization or expropriation, and government repudiation of external debts. The previously discussed currency risk also has a country risk dimension since exchange controls or foreign exchange shortfalls might preclude timely repayment of interest or principal, and loan restructuring may be necessary. A rare but possible event is loan default. Naturally, these events can have a material impact on the financial condition of U.S. banks that make loans in the foreign country.

Forms of International Lending

Trade Financing

The most important single function of international banking departments, both in

volume and significance, is the financing of international trade. Several kinds of trade credit facilities are utilized, depending on circumstances, but the most prevalent is that via letters of credit/bankers acceptance financing. In view of its widespread use, this credit procedure is discussed in some detail. Letters of credit are issued in many forms for many different circumstances and types of transactions, but the two most common types are the commercial documentary letter of credit and the unsecured standby letter of credit.

A commercial documentary letter of credit is an instrument in which a bank (issuing bank) undertakes to pay a party (the beneficiary) named in the instrument a sum of money on behalf of the bank's customer (account party). The beneficiary will be paid when he submits to the issuing bank specific documents as required by the terms of the letter of credit.

Therefore, through a letter of credit, the bank substitutes its creditworthiness for that of the account party. Issuance and negotiation by banks of letters of credit are governed by the "Uniform Customs and Practice for Documentary Credits", publication Number 400 of the International Chamber of Commerce. All letters of credit must be issued: in favor of a definite beneficiary; for a fixed or determinate amount; in a form clearly stating how payment to the beneficiary is to be made and under what conditions; and with a definite expiration date.

The usual routing of a letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. The two basic forms in which the correspondent bank will receive the letter of credit are either the "revocable" or the "irrevocable" form.

The revocable form is, in principle, of little use to the exporter. As the term indicates, the importer's bank can revoke its credit if requested to do so by its principals (the buyers) or amend its terms, either one without the specific agreement of the beneficiary. Ordinarily an exporter would request an irrevocable letter of credit. In this case the buyer could not instruct his bank to rescind or change the letter of credit without securing the consent of the exporter. When the exporter presents his documents exactly as described in the letter of credit to the correspondent bank, the

latter will be able to secure payment from the importer's bank.

The advantages of financing exports by way of an irrevocable letter of credit are obvious. The buyer arranges issuance of the credit with his bank and by the terms of the credit lists the proof he needs of shipment of the merchandise for which he is paying. The exporter, by presenting documents in accordance with the letter of credit terms, will receive payment from a bank. An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay upon presentation of the documents. The letter of credit may be sent directly to the exporter by the issuing bank or through a local bank which is a correspondent of the issuer. In the latter case, the correspondent may merely "advise" the letter of credit. This means that it is acting as an agent of the importer's bank without any commitment on its part. This is evidenced by a printed clause appearing in these credits reading, "This advice is not an engagement on our part, but is simply for your guidance in preparing and presenting drafts and documents".

Some exporters, especially when not familiar with the issuing bank, require an undertaking from bankers in their own country. For this purpose the correspondent bank will "confirm" irrevocable credits by its correspondent (the issuing bank) upon the latter's authorization and the former's willingness to do so. Now the exporter has a definite undertaking from a bank in his country that it will pay upon presentation of documents in accordance with the terms of the letter of credit. This is evidenced by a printed clause by the confirming bank reading, "We undertake that all drafts drawn and presented as above specified will be honored by us."

Payment terms of a letter of credit usually vary from sight to 180 days, although special forms of letters of credit, allowing for terms other than the above exist. Usually the letter of credit will call for drafts to be drawn on the advising (and confirming) bank. If drawn at sight, the bank will effect payment immediately, provided the terms of the credit have been met. If drawn on a time basis, the bank will accept the draft which thereafter can be held by the exporter or by the bank on his behalf until maturity. Alternately, the accepted draft can usually be discounted or sold

at going market rates. (Refer to the section on Acceptances.)

The importance of documentation is paramount in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions evolving from letters of credit to sight drafts or acceptances or to notes and advances, collateralized by trust receipts or warehouse receipts. Ultimate repayment often depends upon the eventual sale of the goods involved. Although the transaction passes through various sections of the International Division, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

All commercial documentary letters of credit are contingent liabilities and are included as such in Reports of Condition. Banks should also control the volume outstanding through a general ledger memorandum account or contra accounts.

A standby letter of credit guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). Whereas a commercial documentary letter of credit is normally payable against the presentation of documents conveying or securing title to goods, such as a bill-of-lading, a standby letter of credit is normally unsecured and payable against a simple statement of default or nonperformance. Some of the most common purposes for which this instrument may be used are:

1. Standby credit for the account party's performance under a contract award in which case, the beneficiary would present to the issuing bank a draft accompanied by a statement to the effect that the contract bidder (account party) did not perform under an awarded contract. The issuing bank would be obliged to pay the beneficiary and then look to the account party (customer) for reimbursement.
2. Standby credit for the account party's borrowing or advances from another bank which arrangement calls for the issuing bank to reimburse the lending bank if the

account party (customer) does not repay his loan.

3. Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction involves a higher potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument retains nothing of value to protect it against loss whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. Therefore to reduce the unsecured credit risk of standby letter of credit, the issuing bank's credit analysis of the account party or customer should be equivalent to that applicable to a borrower in an ordinary loan situation. Unsecured standby letters of credit are included, along with loans, within a bank's unsecured legal lending limit to one borrower.

For reporting purposes, standby letters of credit are reflected as contingent liabilities in the issuer's Report of Condition. Once drawn upon, the amount of the standby letter of credit becomes a direct liability of the issuing bank.

Issuance of guarantees and securities by an insured nonmember bank is normally regarded as an ultra vires act and prohibited by Part 332 of the FDIC's Rules and Regulations. However, court cases and interpretive rulings have held that banks may issue enforceable guarantees when a direct interest of the bank is served. Instances in which this authority is exercised is in the issuance of steamship guarantees and airway releases. These instruments request a transportation carrier to release merchandise shipped under a letter of credit, but before a bill of lading has been received, and provides indemnity protection against future liability. Moreover, Part 347 (Powers of Foreign Branches) provides for the guarantee of customers' debts or otherwise agree for their benefit to make payments on the occurrence of readily ascertainable events.

All such guarantees are to be combined with standby letters of credit for the purpose of determining a customer's legal lending limit.

Bankers acceptances are a common method of financing international trade. These are used to finance all of the successive stages of the

movement of goods through the channels of trade from the point of origin to the final destination.

A bankers acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a issuance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee) and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping across the face of the draft "ACCEPTED" and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank or honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a bankers acceptance.

Most bankers acceptances are used to finance trade transactions. Accordingly, acceptances are most often created in connection with a letter of credit, although they may arise in connection with collection or open account transactions (refer to Commercial Documentary Letters of Credit). In general, acceptance credit is considered self-liquidating; i.e., it must provide the means for its own payment at maturity. In order to accomplish this, the acceptance must be based on a specific, completed business transaction in which goods are being shipped prior to entering the channels of trade. It is therefore reasonable to expect satisfactory evidence to be available indicating that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance from the payee, its "Customers Liabilities on Acceptances Outstanding" (asset) and "Liability for Acceptances Executed and Outstanding" (liability) accounts are reduced and the discounted acceptance is recorded with other

loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance should be rebooked in both the asset and liability accounts. The asset and liability accounts may differ on occasion when the asset account is reduced by the customer's prepayment (anticipation). In that case, the bank's liability, which exists so long as the draft is still outstanding in the market, is not reduced.

Creation of eligible bankers acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Regulation A issued by the Board of Governors. Bankers acceptances must meet certain criteria described in Regulation A and by the Federal Open Market Committee (FOMC) in order for the instrument to be eligible for either discount or purchase by Federal Reserve Banks. Information concerning the criteria used for determining eligibility and an explanation of the terms "discount and purchase by the Federal Reserve Banks" can be found in standard references. Federal Reserve Banks have not, however, "discounted" acceptances of member banks for many years. In addition, the Federal Reserve Bank of New York, which conducts acceptance operations for the System under the direction of the FOMC have discontinued "purchasing" acceptances for its own account. Despite the fact that acceptances are currently not being either discounted or purchased by Federal Reserve Banks as a matter of policy, the rules governing whether an acceptance meets the eligibility requirements continue to be important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the market than are acceptances which do not satisfy these conditions, and as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances are subject to reserves (eligible acceptances are not) which raises the cost to the borrower over that of an eligible acceptance.

Bankers acceptances as a source of finance and investment offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, the banker's acceptance has often been a cheaper financing vehicle than a loan or advance since it is readily marketable and considered an important secondary reserve for the accepting bank and is a relatively secure instrument to the investor because of its

two-name backing.

The market for bankers acceptances is made by dealer firms recognized by the Federal Reserve System. Participants in the market, in addition to recognized dealers, are domestic and foreign accepting banks, dealer banks, nonrecognized dealers, Edge Act Corporations, and investors of all types, ranging from individuals to foreign central banks. Although most trading is now done on a negotiated basis, published bid and asked prices are useful indicators of the actual negotiated prices. Generally, secondary market activity in acceptances has not been substantial. Most investors who buy acceptances do not resell them, but hold them until maturity so that, once placed with the investor, relatively few find their way back into the market. Thus, accepting banks are the major source of supply to the acceptance market and their willingness to sell their acceptances varies significantly with changes in general money market conditions. Both accepting and nonaccepting banks are also important buyers of other banks' acceptances as an investment when rates on acceptances are attractive compared with other short-term obligations. Since the banks' holdings of acceptances form part of their secondary reserves, it is important that the paper they buy be readily marketable by conforming to all the rules which make the acceptance eligible for discount by a Federal Reserve Bank.

Lending limits affecting bankers acceptances in nonmember banks are controlled by State banking laws but most of the States which are oriented toward international banking have adopted the appropriate sections of the Federal statutes (12 U.S.C. 372). Under this law, commonly known as Section 13 of the Federal Reserve Act, no limit is placed on the volume of eligible acceptances a bank may hold that originates with an individual customer if the acceptance is secured by collateral growing out of the same transactions as the acceptances. Other acceptances, including those which do not conform to the collateral requirements, are subject to a 10% of capital limitation. However, these parameters are separate from and in addition to conventional lending limits. Aggregate eligible acceptance volume under Section 13 is limited to 150% of capital which may be increased to 200% with permission of the Federal Reserve.

While most bank trade financing is provided via letters of credit and bankers acceptances, several other methods are utilized in various circumstances. Three of the more common are current account advances, foreign receivable financing, and discounting trade acceptances.

Current account advance is the American substitute for the European method of financing by overdraft. Current account advances are extensions of credit in which no instrument of specific indebtedness is used. Instead, a signed agreement is on file stating the conditions applicable for payment by the obligor.

When financing foreign receivables by advances against foreign collections, the exporter pledges his outward collections to the bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables lodged with the bank at any one time. Besides having a pledge on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime consideration. The bank also maintains control of the merchandise by ensuring that the export bill of lading is "to the order of" the shipper and endorsed in blank or to order of the bank. The bill of lading must not be consigned to the buyer (importer) since this gives him control over the goods.

The bank may also finance foreign receivables by discounting trade acceptances. The exporter's draft accepted by the foreign buyer becomes a trade acceptance with the full credit obligation of the importer. The acceptance is returned to the exporter. If the exporter does not need bank receivable financing, he simply asks the collecting bank to present the draft to the acceptor (importer) for payment at maturity. If the exporter needs the funds before maturity of the trade acceptance he may ask the bank to discount the draft with or without recourse to himself (exporter). For the most part, however, the lending bank retains the right of recourse to the exporter, if the primary obligor (importer) defaults.

Banks also finance foreign receivables by bankers acceptances. To obtain acceptance financing against receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer) which, along with the necessary documents, is sent for collection in the usual

manner. The second, for the same or a lesser amount and for the same tenor as the first, is drawn on the exporter's bank. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank may hold the acceptance in its loan portfolio or may sell it in the market. When payment is received from the importer on the first draft, the bank applies the proceeds to pay its own acceptance. Should the importer default, the bank has recourse to the drawer (exporter) for payment.

Domestic Loans

Although some loans to domestic corporations are technically international credits, they are essentially domestic loans. A typical transaction would be a loan or other form of credit to a domestic customer to finance imports of inventory shipped on open account or under a letter of credit or bankers acceptance facility. The credit is in U.S. dollars and repayment is expected through the sale of the inventory in the U.S.

Loans to overseas units of domestic corporations are sometimes guaranteed by the domestic corporation. The loans may be made for several purposes such as short-term working capital or long-term capital improvements. The domestic company guarantees generally play a much stronger role in international banking than in domestic lending, and their proper execution is a critical factor in granting the credit. On the other hand, loans to overseas affiliates of U.S. corporations not supported by a guarantee of the domestic corporation, must be considered on their own merits. There may be a verbal agreement between the parent company and the bank or an informal commitment, such as a comfort letter, keepwell letter, or letter of assurance which are not legally binding. Therefore, such loans to overseas affiliates should be evaluated as loans to independent entities.

Loans to Foreign Governments

Loans to foreign governments and government-controlled entities cover not only government-controlled banks, financial institutions, and agencies, but also nationalized industries. Repayment for such loans is dependent upon the government of the country. From a financial viewpoint, countries are generally categorized as

developed, oil-exporting developing countries or nonoil developing countries. The evaluation of risk inherent in such country exposure represented in the international loan portfolio is discussed later under Country Risk.

Direct Credit to Foreign Banks

Direct credit to foreign commercial banks may be in the form of loans or deposit placements. Loans are of the normal business type, similar to domestic loans made to local correspondent banks. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York, London, Frankfurt, Singapore, and Nassau, generally short-term in nature, and carried in the account, Due From Foreign Banks-Time. They involve both foreign banks and overseas branches of U.S. banks and are made under a preapproved placement line which, in essence, is a line of credit.

Indirect Loans to Foreign Banks

Indirect loans to foreign banks are loans extended to a foreign borrower based primarily on the foreign bank's guarantee of the loan. In fact, such credit extensions are often accommodations to the foreign bank, with little or no contact between the lending bank, and the direct borrower. For all practical purposes, such loans are part of the credit extended to the foreign bank for funding purposes.

Loans to Foreign Business or Individuals

Direct loans to foreign businesses and individuals are based on the same credit principles as domestic commercial loans. However, the examiner must consider them in the special environment of international business which may influence their repayment. Country risk, foreign exchange risk, and reliability of financial statements are some of the factors in this environment.

Syndicated Project Loans

Project loans put together by international consortia and participations in syndications are specialized loans which are often managed by another bank and may or may not involve existing customers. Nevertheless, the commercial bank

under examination should have sufficient financial information and documentation on hand to ensure an adequate understanding of the transaction, the borrower, the risks involved, and the source of repayment.

International Lending Policy

Every bank engaged in international lending should be guided by a formal statement of policy approved by its board of directors. Content will vary depending on the size of the bank and the extent of its international commitment, but certain factors tend to be general. These would most often include a summary of management's basic credit standards, a statement of the bank's international lending objectives, a description of its system for credit approval, a recital of loan processing procedures, and establishment of specific personnel lending authorities. Additionally, the policy should establish procedures which assure that the board of directors will regularly be apprised of the condition of the international loan portfolio. While the policy should remain conceptual, it will frequently be appropriate to indicate the major differences in international versus domestic lending. These differences have been summarized under the categories set forth below.

Credit Standards and Information - In the evaluation of international credit risk, special consideration must be given to a review of foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and official financial institutions. Bank personnel should be alerted to the need of reviewing, with caution, financial statements prepared in other countries, since accounting practices vary widely and even some highly developed countries have surprisingly lax auditing standards compared to the United States. Foreign financial statements may be prepared in either U.S. dollar equivalents or in a borrower's local currency. Most banks analyze the foreign currency statement, particularly if that currency is unstable and the comparability of figures stated in U.S. dollar equivalents at various dates would be distorted by the fluctuating exchange rates. Nevertheless, banks should also translate and spread the foreign financial statement into English, with the foreign currency converted to U.S. dollars and the applicable exchange rate indicated. Since financial information from

foreign countries is not always reliable, the bank's policies should enable it to determine borrower capacity and reputation by other means. One of the most effective methods is a program of regular visitations to borrowers' countries by bank account officers followed by preparation of candid reports which become significant parts of credit files.

Loans to foreign banks represent an important segment of international credit. Lending to these institutions involves the same uncertainties as other foreign borrowers, particularly in regard to the usual absence of information concerning their asset quality. Within this framework, the key to evaluating a foreign bank is an accurate appraisal of its management. Other important factors are an understanding of the country's banking structure, the central bank's financial position, the condition of the country, and the position of comparable banks. As with international borrowers generally, there is no substitute for regular bank account officer visitations in developing this type of information.

Another factor in international credit analysis is a consideration of the type of domestic borrowers with which international departments do business. Some domestic borrowers are major companies who enjoy excellent credit standings, while others may include sole proprietorship import/export companies operating on modest capital and narrow spreads. Loans to foreign borrowers are often directly or indirectly supported by a party of substantial financial strength such as a domestic parent or affiliate, a foreign correspondent bank guarantor, or foreign government. An evaluation of that support will be basic to a given credit's analysis.

Geographic Limits - The defining of geographic loan limits is probably the most significant component in the establishment of an adequate international lending policy. It requires bank management to intelligently estimate where it can lend profitably in accordance with its marketing objectives, financial capacity and personnel resources. Maximum credit lines should be established for each individual borrower, and maximum aggregate lines established for each political entity where credit is advanced, based on country risk analysis. Country risk is detailed in the following paragraphs and refers to the

favorable or adverse effects arising from the economic, social and political environments of countries in which a bank extends credit. Detailed in a preceding paragraph is the notion of currency risk. This refers to the potential loss on loans made in foreign currencies that may decline relative to the U.S. dollar or to the impact of foreign currency devaluations. Aggregate country loan limits should include a currency sublimit in order to control currency loss exposure.

III. COUNTRY RISK

Introduction

Because of the increased volume of international lending by U.S. banks, the three Federal bank regulatory agencies have adopted a uniform approach to analyzing country risk. This section briefly describes country risk, and how the three Federal agencies evaluate various aspects of that risk in bank examinations.

Concept of Country Risk

For the most part, risks in international lending are the same as in domestic lending. Commercial credit risks stemming from present and future standings of the borrower must be appraised and evaluated in the usual manner. However, international lending presents an additional risk component, i.e., country risk. It is the primary factor that differentiates international lending from domestic lending. In broad terms, country risk encompasses an entire spectrum of risks arising from economic, social, legal, and political conditions of a foreign country that may result in favorable or unfavorable consequences for borrowers in that country. Specifically, country risk analysis includes assessment of the likelihood of political or social upheaval, nationalization or expropriation, government repudiation of external debts, and exchange controls of foreign exchange shortfalls that might preclude timely repayment of interest or principal on external obligations. In these circumstances, payment of interest or principal may be delayed or loan restructuring may be necessary. A rare but possible event is actual loan default. Naturally, these events can have a material impact on the financial condition of the U.S. banks that make loans in the foreign country.

The interagency system focuses primarily on the impact of transfer risk on the bank's loan and investment portfolio in given countries. In general, transfer risk is relevant whenever a bank extends credit across international borders and the extension of credit is denominated in a currency external to the country of residence of the obligor. In these circumstances, an obligor must, in the absence of the ability to earn and/or borrow and retain foreign currency outside the country of residence, obtain the foreign currency needed to service an obligation from the central bank of the country. Where a country is beset by economic, political or social turmoil leading to shortages of foreign currencies at the central bank, the borrower may be unable to obtain the foreign currency and thus default on the obligation at the lending bank or alternatively request a restructuring of the debt.

Interagency Approach

The uniform procedures developed by the three agencies segregates country risk factors from other lending risk analysis and deals with it in a separate section of the examination report. The procedures emphasize diversification of risk as the primary method of moderating country risk. Diversification of risk is a prudent practice for banking and investment in general. It is especially relevant to international lending because the assessment of transfer risk involves major uncertainties and is subject to considerable margin for error. Diversification of risk provides the best protection against a dramatic change in the economic and/or political fortunes of a country.

The adequacy of diversification within a bank's international portfolio is determined by comparing individual country exposure to the bank's capital funds. Depending on the economic and political situation within a country and the structure of the bank's portfolio within that country, different concentration levels are used to identify significant country exposures. Countries are grouped into three general categories of transfer risk; strong, moderately strong and weak. The appropriate levels of capital funds for listing and commenting upon large exposures varies between the three groupings and is described in detail in the Bank of Anytown Supplemental.

When a country is experiencing political, social, or economic conditions leading to an interruption in debt servicing by obligors within the country or when an interruption in payments appears imminent, credits within the country will be designated as Other Transfer Risk Problems (OTRP), or will be adversely classified using the designation of Substandard, Value Impaired or Loss.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability, should also be extended for special comment or classification, as applicable. Contingent liabilities extended for classification should be classified according to the type and tenor of the bank asset which would result from conversion of the contingency into an actual liability. For example, commercial import/export letters of credit would be accorded the same classification as trade transactions, while commitments to fund long-term project loans would be accorded the same classification as long term loans. In cases where type or tenor is not easily discernible and where exposure is accorded a split classification, the more severe classification should prevail.

An Other Transfer Risk Problem (OTRP) designation applies when:

1. A country is not complying with its external debt service obligations, as evidenced by arrearage, forced restructuring, or rollovers; however, the country is taking positive actions to restore debt service through economic adjustment measures, generally as part of an IMF program.
2. A country is meeting its debt obligations, but non-compliance appears imminent.
3. A country has been classified previously, but recent debt service performance indicates classification no longer is warranted. For instance, the country is complying with the terms of IMF and rescheduling programs. However, sustained resumption of orderly debt service needs to be demonstrated.

A Substandard classification applies when:

1. A country is not complying with its external service obligations, as evidenced by arrearage, forced restructuring, or rollovers; and,
2. The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program; or
3. The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

A Value Impaired classification applies when:

1. A country has protracted arrearage, as indicated by more than one of the following:
 - a. The country has not fully paid its interest for six months;
 - b. The country has not complied with IMF programs (and there is no immediate prospect for compliance);
 - c. The country has not met rescheduling terms for over one year;
 - d. The country shows no definite prospects for an orderly restoration of debt service in the near future.

A Loss classification applies when:

1. The loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by a country which repudiates obligations to banks, the IMF, or other lenders.

The assignment of adverse classifications and the designation of countries as other Transfer Risk Problems (OTRP), Strong, Moderately Strong or Weak transfer risks are the responsibility of the Interagency Country Exposure Review Committee (ICERC). The Committee is comprised of nine members (three participants from each of the Federal bank regulatory agencies). Aided by balance of payments statistics, studies of country

conditions and information from various sources, the Committee reaches decisions on the extent of risk posed by underlying economic, political and social circumstances in major countries where U.S. banks extend credit. Where appropriate, the Committee prepares a standard narrative on the country to be used in reports of examination.

Although the Committee results provide the examiner with significant input in assessing a bank's international portfolio, country risk examination procedures have been structured to allow for flexibility and individual examiner judgment. This is particularly true in determining whether concentrations in certain countries warrant comment given the composition of the bank's portfolio in the country, the capabilities of bank management, and the bank's capital position.

The International Lending Supervision Act of 1983 (ILSA) legislated certain other procedures that should be evaluated during the course of an examination. Among other things, ILSA requires the FDIC to take country risk factors into account when evaluating a bank's capital adequacy. In addition to countries which are not adversely classified due to transfer risk, large exposures to other countries which are not adversely classified may warrant highlighting on the Examiner's Comments and Conclusions page if the exposures are large relative to the bank's capital position. ILSA and the FDIC's implementing regulation (12 CFR Part 351) also set forth the requirements on Allocated Transfer Risk Reserves (ATRR), accounting for fees on international loans, and reporting and public disclosure of international assets. Compliance with these provisions should be determined and documented during the course of an examination. The Federal banking agencies are directed by ILSA to require banks to establish and maintain a special reserve when the value of international loans has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or no definite prospects exist for orderly restoration of debt service. The Act requires that the special reserves established by a charge against current income be segregated from the bank's general "allowances for possible loan losses" ("APLL"), and not be included as a part of bank capital. The Act also directs each appropriate Federal banking agency to require a banking institution to establish and maintain a special reserve whenever

in the judgment of appropriate Federal banking agency:

1. The quality of such banking institution's assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors as: (i) a failure by such public or private borrowers to make full interest payments on external indebtedness; (ii) a failure to comply with the terms of any restructured indebtedness; or (iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or
2. No definite prospects exist for the orderly restoration of debt service.

The determination of the Allocated Transfer Risk Reserve (ATTR) is conducted on an interagency basis by ICERC. ILSA also charges each agency with ensuring that fees in excess of administrative costs on international loans be amortized over the life of the loan, rather than being taken up front, as had been the practice. In addition, ILSA directs the agencies to require banking institutions to publicly disclose information regarding material foreign country exposure in relation to assets and to capital.

Analysis of the Country Exposure Management System

An important part of the examination process is the examiner's evaluation of the bank's procedures for measuring exposure, the bank's system for establishing country limits, and the bank's capacity for analyzing countries. The results of the examiner's evaluation should be included, in narrative form, on the report page entitled "Analysis of the Country Exposure Management System."

The three Federal bank regulatory agencies have developed guidelines and procedures to be used by examiners in evaluating systems employed by banks to monitor and control country risk elements in international loan portfolios. The evaluation of country risk should include an in-depth review of the systems employed by banks to monitor and control this unique facet of international lending. Although the sophistication

and composition of these systems varies from bank to bank, depending upon the bank's size and commitment to international lending, certain basic elements described herein should be included to ensure that this segment of the bank's business is being managed properly. The following narrative comments, guidelines, examination objectives, examination procedures and internal control questionnaire are intended to provide guidance to the examiner in the review of bank country risk management systems. Generally, while all banks should have systems for appraising, monitoring and controlling their foreign lending activities, these systems may differ from bank to bank in terms of what is measured as outstanding exposure. For example, some banks may not include local currency lending by foreign offices, or contingent credits, or advances by the bank to its own offices abroad. There is also considerable variation in the degree of support or security required to shift risk from one country to another, and the organizational coverage of the reporting system (i.e., some banks do not include all domestic offices or majority-owned foreign subsidiaries in their reporting). Other important areas of difference include the independence of country risk assessments and control from marketing considerations, the capability within each bank to make country judgments on the basis of analysis and first hand knowledge of the country, the centralization and formality of procedures, and the level of review.

Given the variations in bank systems, country risk management systems should consist of three important components. One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where bank funds are at risk. These so-called "country studies" are derived from economic data supplied by the borrower or published by institutional lenders; social-political commentaries; on-site reports from bank branches, subsidiaries or affiliates; and/or through bank officer visits to the country. The second component involves an undertaking by the board of directors and senior management to define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk assets by country, which serve as a guide to operating management in the development and servicing of the bank's international portfolio.

The third component is the bank's internal reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk assets to the country of risk, to assure adherence to the policy directives of the board, to provide for at least an annual review of portfolio composition in individual countries, and to establish a clear-cut methodology for reporting exceptions to established limits.

The primary examination objectives of evaluating country risk management systems are:

1. To determine if policies, practices, procedures, and internal controls regarding country risk management are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the impact of country risk on the overall quality of the international loan portfolio.
4. To initiate corrective action when policies, practices, procedures, and internal controls are deficient.
5. To prepare narrative commentary on the bank's country risk management system in a concise, reportable format.
6. Where deficiencies exist, to prepare appropriate comments for inclusion in the Report of Examination.

Country Risk Examination Procedures are as follows:

1. Obtain the following from a review of the minutes and reports of the board of directors:
 - a. A copy of written policies covering country risks.
 - b. The name and composition of the committee charged with the responsibility for administration of country risk.
 - c. Copies of the latest country risk exposure reports furnished to the board for its meetings.

2. Review international lending policies on:

- a. Country exposure limitations and/or aggregate limitations such as geographic area, income level or common commodity.
- b. Limits or sub-limits on loans by category (e.g., trade credits, banks placements, term-loans, secured loans).
- c. Maximum maturities for various categories of loans pertinent to the evaluation of country risk.

3. Review reports furnished to the board and the appropriate committee to assure that comprehensive and accurate information is being submitted on a timely basis.

4. Obtain and review the bank's written analysis of individual country conditions.

5. Obtain the bank's report on the general distribution and characteristics of the international loan portfolio and:

- a. Determine the percentage of international loans in specific categories.
- b. Compare loan category distributions for adherence to guidelines.

6. Complete the Country Risk Internal Control Questionnaire.

7. During discussion with senior management, structure inquiries in such a manner as to:

- a. Gain insight into management's international lending philosophy.
- b. Elicit management responses for correction of deficiencies.

8. Prepare, in appropriate report format, general remarks on:

- a. The quality of internal policies, practices, procedures and controls over the international lending function.
- b. The general level of adherence to internal policies, practices, procedures

and controls.

- c. The scope and adequacy of the internal loan review system as it pertains to country risk.
 - d. The scope and adequacy of the bank's analysis of country conditions.
 - e. Causes of existing problems.
 - f. Expectation for continued sound international lending or correction of existing deficiencies.
 - g. Promises made by management for correction of deficiencies.
 - h. The quality of management with respect to the monitoring and controlling of country risk.
9. Review any country exposure reports filed since the last examination for accuracy.
 10. Review public disclosure of country risk exposure for completeness and accuracy.

Country Risk Internal Control Questionnaire

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
 - a. Establish country exposure limits for credits?
 - b. Establish limits for distribution of loans by type and maturity?
 - c. Acknowledge concentrations of credit within countries and the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country condition

and/or levels of exposure brought to the attention of the board of directors or its designated committee in a timely manner?

4. Are country limits revised in response to substantive changes in economic, political and social conditions within particular countries?
5. Are country limits revised and updated at least annually?
6. Prior to granting additional advances or commitments, are outstandings checked to appropriate country limits?
7. Are lending officers cognizant of specific country limits?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic lending officer call program for countries?
10. Is there an internal review system which determines that international risk assets outstanding and committed are within the bank's foreign country exposure limits?
11. Are country risk factors (economic, political, and social) in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank's system for maintaining adequate and current country analysis information include the following?
 - a. A review of country conditions on a regular basis (state frequency and indicate who performs analyses)?
 - b. A continuing review of current country data obtained from internal as well as external sources?
 - c. An analysis of economic, political, social and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?

14. Does the bank's country risk evaluation system accurately recognize exposure from country to country on the basis of legally binding guarantees, collateral, or reallocation by office of responsibility?
15. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?

Country Risk Exposure Report

One of the tools used in monitoring a bank's country risk exposure is the Country Exposure Report (FFIEC 009), which must be filed quarterly by banks which meet certain conditions. Those conditions as well as the detailed instructions for compiling the report are contained in the Instructions for Preparing the Country Exposure Report (FDIC Form 6502/03). The examination process should include insurances that banks adhere to reporting requirements, and that such reports are accurate.

IV. FOREIGN EXCHANGE

Foreign exchange trading is a complex and highly specialized field and is usually performed by specialists. It is an integral part of international trade and can be an important activity of a bank's international department. This section is intended to present only the basic fundamentals of foreign exchange in order to provide the examiner a minimum basis for evaluating a bank's activities. Examiners are encouraged to study the subject in more detail. A number of books about foreign exchange are available and several major U.S. banks have published books or pamphlets on the subject. The examiner should also be familiar with the FDIC's policy concerning minimum standards for various aspects of foreign exchange operations. This policy is reviewed later in this section.

Foreign Exchange Market

The simplest definition of foreign exchange is that it is the exchange of money of one country for money of another. Foreign exchange transactions arise out of international trade or the movement of capital between countries. Market activity takes place between banks (interbank trading) and

between banks and their customers (corporate trading), who are the ultimate users and suppliers of foreign currencies. The volume of foreign exchange activity varies widely among banks. The degree of involvement is largely dictated by customer demand and the bank's own needs. Multinational banks are the most active in terms of both trading volume and the number of currencies traded. Some banks may trade actively in only a few currencies while other banks will have only limited overall activity. In any case, the examiner should possess some basic knowledge of the foreign exchange market and the risks involved.

Exchange Rates

When currencies of different countries are exchanged, it is done at an exchange rate which is simply the price of one currency in terms of another. Many political and economic factors influence exchange rates. A government may attempt to fix the rate of exchange for its currency or allow it to fluctuate freely or within established limits. Trade and investment flows affect the supply and demand for currencies which in turn influence exchange rates. Banks also quote different rates based upon the amount of time required to exchange currencies. For example, the British Pound Sterling is quoted at a certain rate for immediate (spot) transactions and another rate is quoted on the same day for future (forward) transactions. In general, rates vary depending on the agreed payment date (value date) of the transaction, e.g., overnight, one week, one month, etc. Also, banks quote a different exchange rate for a given transaction when they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as bid (buy) and offer (sell). The spread between the bid and offered rates represents the bank's profit margin.

Exchange rates can be quoted either as direct rates or cross rates. Direct rates are simply the value of a currency in terms of another, e.g., the value of the German Mark in U.S. Dollar terms. A cross rate is defined as the price of one currency in terms of another currency in the market of a third country, e.g., a German Mark rate in Sterling terms calculated from the respective U.S. Dollar rates.

Spot and Forward Exchange

Customers buying or selling foreign exchange may ask their bank to provide that service for immediate delivery (spot transaction) or they might contract to buy or sell a specified amount of foreign currency for delivery at a future date (forward transaction). The date on which payment is effected is referred to as the value date. The value date for a spot transaction is generally two working days after the date the transaction originated. For example, a spot contract originating on Monday would have a value date of Wednesday.

The market for foreign exchange for future delivery is called the future or forward market as opposed to trading for two-day delivery which takes place in the spot market. A forward contract for foreign exchange is a transaction in which one currency is bought or sold against another for delivery at some future date. It differs from the spot market in that settlement occurs in the future, usually in increments of thirty days out to one year for most currencies. However, the liquidity in the market decreases beyond three months. As previously noted, the exchange rate for a specific currency will differ between spot and future transactions because of the time difference in settlement dates.

An exchange rate is fixed or agreed upon when the forward contract is entered into but no money is exchanged until the agreed future date (value date or settlement date) arrives. This type of contract enables a company or an individual who has a future commitment in a foreign currency to eliminate the risk of an adverse move in the rate of exchange prior to the maturity of the commitment. Forward exchange rates are usually quoted in terms of their premium or discount over the spot rate. As described above, there is a specific exchange rate for each forward contract and that rate will usually differ from the spot exchange rate. If the forward exchange rate for a currency is higher than the current spot rate for the same currency, the currency is said to be trading at a premium for the forward maturity. If the forward rate is below the spot rate, the currency is said to be trading at a discount. The amount of the premium or the discount is generally determined by the interest rate differential for similar money market instruments that exists between the two countries.

Another type of forward contract is the forward option contract. A forward exchange transaction is often based on expectations of payments involved in future trade or financial operations, but it may be difficult to know the exact date. If the customer knows the approximate date when the currency will be received or needed he can enter into a foreign option contract. The contract may give the purchaser the option of completing a transaction in the first ten days, the middle ten days, or the last ten days of the month. The bank agrees to deliver payment or receive delivery of payment of exchange on any day within the ten-day option period. The customer is charged a less favorable rate for the advantage of leeway in timing the execution of the contract than he would be for a regular forward contract.

Swaps

Another common type of foreign exchange transaction is known as a financial swap, which is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. For example, an exchange trader buys a currency for spot value and at the same time sells it back for a value date in the future. The swap permits a temporary exchange of currencies and is often used to acquire a foreign currency which is then used to make a short-term investment. The maturity of the investment will coincide with the forward value date and the currency will be returned at that time. The exchange rate for the forward delivery is fixed at the outset thus the trader avoids the risk in fluctuations in the exchange rate over the life of the investment.

Foreign Exchange Risk

Trading in foreign exchange or holding assets and liabilities denominated in foreign currency entail certain risks. These risks fall into five categories; exchange rate risk, interest rate risk, credit risk, country risk, and operational risk.

Exchange Rate Risk occurs when a bank takes an open position in a currency. When a bank holds, buys, or agrees to buy more foreign currency than it sells, or agrees to sell more than it buys, an exposure is created which is known as an open position. Open positions are either long or short.

When a bank buys more of a currency, either spot or forward, than it sells, it has a long position. Conversely, if more of a currency is sold than bought, a short position is created. Until an open position is covered by the purchase or sale of an equivalent amount of the same currency, the bank risks an adverse move in exchange rates. A long position in a depreciating currency results in exchange loss relative to book value. As the foreign currency depreciates, it is convertible into fewer units of local currency. Similarly, a short position in a currency that is appreciating results in an exchange loss relative to book value because, as the currency increases in value it costs more units of local currency to close or square the position. To control exchange risk, bank management should establish limits for net open positions in each currency. A detailed discussion of limits appears in the section entitled Trading Limits.

Interest Rate Risk is also known as maturity-gap risk. It arises whenever there are mismatches or gaps in a bank's total outstanding spot and forward contracts. Gaps result in days or longer periods of uneven cash inflows or outflows. For example, a maturity spread of a bank's assets, liabilities, and future contracts may reflect a prolonged period over which large amounts of a particular currency will be received in advance of any scheduled offsetting payments. The exposure to the bank is that of adverse shifts in interest rates earned on funds provided by cash inflows or on interest rates paid on funds required to meet cash outflows. In this situation the bank must decide whether; (1) to hold the currency in its "Nostro" accounts; Nostro accounts or due from accounts are accounts established in correspondent banks located in the countries where the bank conducts business. The bank will maintain an inventory of currency, i.e., British Pound Sterling in London, in order to complete transactions requiring the receipt or payment of Pounds. See "Other International Department Activities" for more details. (2) to invest it short term; (3) to sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes; or (4) to use any combination of the above.

Banks control interest rate risk by establishing limits on the volume of mismatches in its total foreign exchange position. The problems of managing gaps is complex. The decision whether

to close a gap when it is created, or leave it until a later date, is based upon analysis of the money market interest rates, and spot and forward exchange rates.

Credit Risk - When entering into a foreign exchange transaction, the bank must be confident that its customer (individual, company, or bank) has the financial means to meet its obligations at maturity. Two types of credit risk exist in foreign exchange trading; one is called the 10-20% risk or the cost cover, the second is delivery or settlement risk. The 10-20% risk is that a customer might not be able to deliver the currency as promised in order to execute the contract. The bank's foreign exchange position is suddenly unbalanced and the bank is exposed to any movements in exchange rates. The bank must either dispose of the currency it had acquired for delivery under the contract, or it must purchase the currency it had expected to receive and probably had contracted to sell to a third party. In either case, the bank must enter into a new transaction and may suffer a loss if there has been an adverse change in exchange rates. Generally, exchange rates will fluctuate no more than 10-20% and usually much less, hence the term 10-20% risk.

Delivery or settlement risk refers to the risk of a customer taking delivery of funds from the bank but not delivering the counterpart funds. In this situation the bank is exposed for 100% of the transaction.

To limit both types of risk, a careful evaluation of the customer's creditworthiness is essential. The credit review should be used to establish an overall limit for exchange contracts for each customer. For example, after careful analysis of the customer's financial soundness, the bank may determine an overall limit for foreign exchange contracts for the customer in the equivalent amount of \$2 million.

With this total limit the bank might establish a settlement limit of no more than the equivalent of \$200,000 in any one day. In this manner it has limited its 10-20% risk to 10% of any outstanding contracts to a maximum of \$2 million. At the same time it has limited its delivery or settlement risk by imposing a \$200,000 settlement limit. If the customer fails to deliver counterpart funds, the bank can cancel remaining contracts and limit its

risk of loss.

Country Risk - Political changes or adverse economic trends within a country are likely to be accompanied by changes in policies which could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. These policies, whether based on economic necessity or changed attitudes, might affect the availability of exchange to the bank's customers or to the bank itself, and could even affect the convertibility of that country's currency in foreign exchange markets. In any case, the exchange rate for the currency will be subject to additional supply and demand influences, and sources of cover in the currency may vanish. Country risk is covered in more detail in preceding paragraphs.

Operational Risk - Banks that engage in foreign exchange transactions must have systems and personnel capable of controlling and reporting transactions. The absence of an effective operations department may result in unanticipated losses to the bank. Generally, the bank will have an Operations Manager whose responsibility is to ensure that systems are in place to record transactions, perform daily mark-to-market, reconcile currency positions daily, and assess compliance with limits. The Operations Department should also ensure that all confirmations are received or sent to counterparties daily.

EXAMINATION GUIDANCE

An examination of a bank's foreign exchange activities seeks to appraise the impact of the foreign exchange activities on the financial condition of the bank. To obtain this objective the following procedures may be used:

1. Determine the reasonableness of FX activities in regard to bank policies and strategies, expertise, operations, internal controls, management information systems, and internal audit coverage.
2. Evaluate the overall FX risk position of the bank, its potential impact on future earnings, and management's ability to manage the risk.

3. Determine the type of FX activities and risks in which the bank is engaged (spot, forward, swaps, options, futures).

4. Evaluate the quality of personnel, risk controls, and systems.

FDIC POLICY

In June 1980, the three Federal bank regulatory agencies implemented a joint policy statement to provide banks with uniform guidance regarding internal control of foreign exchange activities. The policy statement covers minimum standards for written bank policies, basic internal control, and audit documentation. Examiners working in the area of foreign exchange should be familiar with the policy guidelines and should use them as a framework for examination activities.

The FDIC recognizes that many banks already have adequate controls in place for foreign exchange trading. The guidelines are intended to reinforce these controls and can be used by examiners, auditors, and bank management as a basis for evaluating the bank's policies and controls. The guidelines are not all-encompassing and banks that actively deal in foreign exchange probably have controls that exceed FDIC standards. On the other hand, it is conceivable that banks with limited foreign exchange activity may not need all the systems included in the guidelines. However, it is incumbent upon these banks to demonstrate that their systems provide adequate protection for the level of risk incurred.

Written Policies and Procedures - The bank's policies and procedures should, at a minimum, address the following:

Scope of trading activity authorized and types of services offered;

Trading and credit limits and limit exception approval and reporting process;

Clear standards for trading with affiliated entities, members of the Board of Directors, and employees;

Specific officer responsibility for and authority over functional trading desks (i.e., spot, forward,

and futures);

Holdovers and after-hours transactions;

Accounting methods; and Operational procedures.

Trading Limits - Trading limits should be evaluated in light of current strategies, liquidity/volatility of individual currencies, trader qualifications, and loss exposure related to capital. At a minimum that bank's policy should include limits with respect to:

Net positions by currency; and aggregate;

Maturity distribution of foreign currency assets, liabilities, and contracts;

Individual customer and bank lines;

Daily settlements with customers and banks;

Total FX contracts outstanding;

Overnight net FX positions by currency and aggregate; and

Maximum loss by trader/desk/branch.

The process by which limits are allocated to branches and the process through which branches may borrow limits from other branches should be reviewed. In addition, policies governing the extension of limits and the approval and reporting procedures should also be evaluated.

Credit Limits - The allocation of credit limits and the monitoring of such limits should be reviewed. The bank should establish the following:

FX counterparty and settlement limits, approved by a credit review process, that are established independently of other credit lines within the bank;

Daily reports generated by FX operations which indicate those customers or banks that have exceeded their limits (sometimes called an over-limit or exceptions report;)

Daily report of limit excesses including written approvals for excesses prepared by an officer not in the trading area;

Systems of allocating more risk to counterparties with long maturity positions;

On-line systems available to traders that detail credit line status.

Examiners should review the list of approved credit limits and note any unusual concentrations or lines to banks with known market problems. A current report of all outstanding FX contracts should be compared with approval limits to verify that there are no other excesses other than those reported on the exceptions report.

Management Information Systems (MIS) and Operational Support - The bank's management information systems (MIS) and Operations Department should be capable of reporting and supporting the level of current and expected trading volumes on a daily basis. Specifically, with respect to the MIS, examiners should review the reports generated and evaluate the systems' ability to monitor all FX positions, compliance with limits (both trading and credit), frequency of distribution (at least daily), and periodic testing for accuracy.

The personnel in the Operations Department should report to someone other than a member of the trading staff. The Operations Department should be adequately staffed to support the volume of transactions and duties of the department should be segregated, i.e., confirmations, trader positions, counterparty positions. There should be sufficient documentation of all transactions to ensure a proper audit trail. Documentation may be in the form of taped records of phone calls and trade tickets and confirmations received via telex, facsimile, recorded telephone calls, or mail. The Operations Department should also review all trader and counterparty position reports and identify and report all excesses to the Operations Manager daily. Documentation for the approval of excesses must be obtained and reviewed each day.

The revaluation or mark-to-market of appropriate positions are calculated by Operations personnel.

Examiners should closely review these revaluations for accuracy and adherence to bank policy. Prices used by Operations personnel should be obtained and verified from sources other than the bank's traders. Revaluations are recorded at least monthly.

Written confirmations should be sent no later than one business day after the transaction date. Incoming confirmations should be reviewed by a designated person in Operations. All confirmation discrepancies must be recorded in a log and promptly corrected. Most banks confirm transactions verbally the day of the transaction, therefore, a large number of discrepancies should be carefully scrutinized by examiners.

Finally, the status of nostro and vostro accounts should be reviewed to identify any outstanding items which may indicate settlement errors in those accounts.

Internal Accounting Controls - The bank's accounting systems and controls should be sufficient to provide reports on trading activities that are current and accurate and minimize the possibility of concealment of unauthorized transactions and misappropriation of funds. Documentation describing the accounting and other controls should be maintained by each trading office.

FDIC guidelines enumerate a number of specific recommendations for adequate internal controls of foreign exchange trading. In broad terms, the recommendations address the description of accounting systems and procedures, confirmation of contracts, reconciliation of trading positions, and reporting of exceptions. As a whole, the accounting guidelines are considered minimum standards for the control of exchange activities. It is possible that the bank can control certain risks in a different manner. In such case, the bank must be able to justify its method of control.

Audit Documentation - The audit function is an important tool for management's use in determining that controls are functioning as intended and that employees are adhering to policy directives. The review of audit reports is a necessary part of an examination particularly in specialized areas such as foreign exchange trading. The failure to extend adequate audit programs to the bank's foreign exchange activity

might be considered an important weakness in the bank's system of controls. In such case, the examiner should address the matter in the examination report and seek corrective action from senior management.

The FDIC's guidelines do not describe how the audit program is to be performed. The development of an adequate audit program is a responsibility of senior management. The guidelines contain recommended minimum standards for documenting audit procedures and findings in a manner that facilitates an appraisal of the adequacy of the audit program.

The bank should maintain audit reports, workpapers, and related files at its head office or another centralized location and make them available to examiners. The auditor's files should indicate the extent to which the auditor tested the control and accounting entries, as well as compliance with bank policy. The auditor should also make a determination as to whether the bank's controls are adequate for the risks involved. The files should contain any recommendations by the auditor for additional controls, or the deletion of existing controls, and the underlying rationale. Any material deficiencies disclosed by the audit should be promptly reported in writing to the board of directors or a board committee.

V. CABLE DEPARTMENT

As international trade and finance have grown, the necessity to transfer large sums of money each day has placed increased importance upon cable transfers. Because of the large sums involved, cable operations should be closely controlled by management.

Cable or wire transactions are sometimes referred to interchangeably. However, the word "cable" is more accurately used to describe a transfer of funds by cable, telex or telegram, and "wire" transfers are those performed via local messages over the telephone. Wire transfers should be made with coded messages and subsequently confirmed by authenticated cable.

Authentication of cable messages is accomplished by using "test keys", which are as valid as an officer's signature on a certified check.

A test key is a code generally consisting of a series of numbers, comprised of a fixed number for each correspondent bank, type of currency, total amount, day and month. To reduce, the risk of fraud, banks generally include a variable number (random number) and/or prefix number in the test key. The use of dance test keys without variable or prefix numbers should be discouraged. A sophisticated test key arrangement is frequently the best method of controlling the risk of fraud in cable operations. The formula used to generate test keys should be kept under dual control and access limited to as few people as possible.

One of the most important controls is the separation of duties so that cable room personnel are not involved in the testing function. Those who transmit and receive messages should not have access to the testing formulas. Another important control regards limits on cable to third parties, i.e., transactions that are not bank to bank. Limits on such transfers should be set by senior management with dual signature verifications required.

In addition to reviewing internal controls and segregation of duties, the examiner should also review the audit program to determine the scope and effectiveness of work performed by the audit staff in this area.

VI. OTHER INTERNATIONAL DEPARTMENT ACTIVITIES

Cash Accounts

International departments, like their domestic counterparts, maintain cash accounts which may vary from nominal sums to large amounts depending on customer needs. These accounts will include U. S. and foreign currencies, collection items and unposted debits. Examination objectives for these accounts are the same as those in domestic operations. Physical control over cash should be maintained and complemented with adequate accounting systems and controls. The department's accounting reports should include the U. S. dollar equivalent of foreign currency balances. Separate controls for cash items should be maintained on the general ledger, supported by subsidiary records which permit an evaluation of each item. Dealing in foreign notes and coins can involve more risk than engaging in foreign currency activity through

a due-from account maintained at a correspondent bank because: 1) The institution may unknowingly accept counterfeit currency and 2) The physical movement of notes and coins is expensive and time consuming. Appropriate internal controls should be instituted to compensate for these additional risks.

Some banks do not include foreign currency in their net position reports or monthly revaluations. However, currency of other countries are foreign currency assets as are loans or nostro accounts and should be included in position reports.

Due-From or Nostro Accounts

A bank must be prepared to make and receive payment in a foreign currency in order to meet the needs of its international customers. Since physical movement of currency is impractical, these transactions are accomplished by maintaining accounts or "inventories" of foreign currency in correspondent banks located in the countries where the bank and its customers conduct business. Account transactions occur in the foreign currency and normal procedure is to record deposits and withdrawals on the department's ledgers in both the foreign currency and its U. S. dollar equivalent. Such due-from accounts of foreign banks are known as "nostro" or "dual currency" accounts.

Close supervision of nostro accounts is required to provide adequate balances to service the needs of customers while avoiding excessive idle funds, or overdrawing the nostro account and incurring service charges. All foreign currency transactions, except over-the-counter cash trades, are settled through the nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled. Incoming confirmations of transactions should be carefully reviewed by the institution to protect against fraud and error. Similarly, timely follow-up procedures should be in place for non-receipt of confirmations.

Examination objectives are similar to those of domestic correspondent accounts with the additional problem of exchange risk. Nostro account balances are included with other general ledger accounts to determine the department's "position" in each foreign currency. Spot and forward contracts taken to cover excessive nostro

overages should be combined with all other exchange contracts to discover "gaps" or maturity mismatches. The institution's credit evaluation of foreign banks with whom demand deposit accounts are maintained should also be carefully reviewed.

Investments

International departments may invest in securities and various money market instruments, i.e., banker's acceptances, commercial paper and repurchase agreements. Foreign securities of governmental entities are the prevalent form of investment and are normally held to meet various local laws or reserve requirements, reduce tax liability, or as an expression of goodwill. However, they may be purchased strictly for investment purposes with the expectation of providing a reasonable rate of return commensurate with the safety of principal. As with the domestic investment portfolio, the purchase of foreign securities with speculative characteristics to generate higher short-term income is an unsuitable investment practice. Prior to purchasing a foreign security, the institution should analyze the following factors relative to the investment: Legal implications, credit soundness, marketability, exchange rate risk, and country risk. This supporting documentation should be retained in the institution's files for examiner review. To assure adherence to written policies and procedures, the international investment portfolio should be reviewed by the Board at least annually.

International investments are often located in the domestic securities portfolio and examination analysis is usually performed in conjunction with the overall review of domestic investments. Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. Limitation of international investments and definition of permissible activities is governed by the Federal Reserve Board's Regulation K which is incorporated into the FDIC Rules and Regulations through Part 347.

Due-From Time Deposits

Banks may maintain interest bearing time deposits with foreign banks and overseas branches of U. S. banks. Referred to by various

terms such as placements, interbank placements or redeposits, maturities of these instruments may range from overnight to several months or years. The bulk of due-from time deposits consists of Eurodollar placements with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of the denomination. The Eurodollar market has grown significantly since 1960 with increased interbank activity stemming from the desire to put idle Eurodollar balances to work or to fund Eurodollar loan requests. Although treated as deposits in the report of condition, due-from bank time deposits contain the same credit and country risks as any extension of credit to a bank in a foreign country. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks after a thorough investigation of their creditworthiness. Placement activity should be governed by a formal bank policy similar to those used for Federal funds transactions. The policy should define terms, designate acceptable levels of concentration in relation to credit and country risks, and identify those banks acceptable for placement activity. Lists of acceptable depositories with prescribed limits should be provided to the traders or placement officers and reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions.

The primary examination objective is to determine adequacy of bank policies. Examination procedures are similar to those performed in the domestic operations and should focus on a review of written policies, internal controls and audit programs. In those instances where a formal policy has not been developed, or credit analysis is nonexistent or deficient, the matter should be discussed with management. Unless the depository institution clearly exhibits pronounced financial deficiencies, in which case the placement can be criticized for its poor credit quality, the examiner's objective is to advise the bank of the potential risks of its practices. The need for correction of any deficiencies should be reinforced through the examiner's comments and conclusions. If the bank's total exposure with any one institution via Eurodollar placements, Federal funds sold, and demand or time balances with the U. S. offices meets the criteria for a concentration

of credit, it should be listed on the appropriate examination report schedule. Also, in the case of placements with foreign banks, these amounts should be included with other foreign extensions of credit for purposes of evaluating country or transfer risk.

Borrowings

All international department transactions that constitute borrowings should be properly recorded on the general ledger, in reports to shareholders, and in published reports of condition. International borrowings exist in the same forms as in domestic banking and are commonly composed of direct borrowings from the Export-Import Bank of the United States, short-term call money from foreign banks, and overdrawn nostro accounts. Other forms of borrowings include: notes and trade bills rediscounted with central banks of various countries; notes, acceptances, import drafts or trade bills sold with the bank's endorsement or guarantee; and, notes or other obligations sold subject to repurchase agreements.

Certificates of deposit and due-to foreign banks - time (takings) have not been defined as borrowings and continue to be reflected as deposits for reporting and borrowing limitation purposes. However, the fundamental distinction between these instruments as deposits or as borrowings is at best nebulous; in fact, they are widely recognized as borrowing vehicles for many banks.

Guidelines presented elsewhere in this manual for evaluating domestic borrowing activity should be used for any borrowings found in the international department. Any unjustified borrowing policy being pursued in the international department should be reviewed with management and appropriate comments included in the report of examination.

VII. LAWS AND REGULATIONS

Several laws and regulations govern certain international activities of banks and some are discussed briefly in this section. Examiners should be familiar with these laws and will find it useful to refer directly to them. They have been made available to the field staff either in the Prentice-Hall volumes or in memorandum form.

Foreign Branches, Subsidiaries, Edge Corporations and International Banking Facilities

Part 347 of the FDIC's Rules and Regulations governs foreign branch and other overseas operations of nonmember banks. The provisions of this Part are similar to those contained in Regulation K of the Board of Governors of the Federal Reserve System which are applicable to member banks. Nonmember banks which operate foreign branches or subsidiaries, are regulated by Part 347. Regulation K applies primarily to member banks but it does govern Edge or Agreement Corporations operated by nonmember banks.

Briefly, Part 347 outlines the application process by which banks may be given permission to operate foreign branches or invest in foreign banks or other financial entities. The powers or permissible activities of overseas branches are defined by the regulations and, generally, these branches are allowed a wider range of financial activity than is permitted domestically. The regulations also establish minimum standards for accounting and internal controls in foreign branches or subsidiaries.

Edge or Agreement Corporations are subsidiaries of banks organized for the purpose of engaging solely in certain types of international financial and investment activities. They may be organized by member or nonmember banks, or by foreign banks, and ownership can be held by one bank or several banks. They are located in the United States but often not in the same state in which the parent bank operates.

An Edge Corporation is a useful vehicle for a growing number of banks that wish to enter the international banking business. It may be located in any part of the United States, can establish branches in this country or overseas, and is permitted to engage in a broad range of banking activity provided the transactions are international in nature or directly related to international transactions. Operations of Edge Corporations are governed by Regulation K and regulated by the Federal Reserve System.

An International Banking Facility (IBF) is a set of asset and liability accounts, segregates on the books and records of the establishing entity,

which reflect international transactions. An IBF is established in accordance with the terms of Federal Reserve Regulation D and after appropriate notification to the Federal Reserve. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement corporation, or a U.S. branch or agency of a foreign bank pursuant to Federal Reserve Regulations D and Q. An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited to non-U.S. residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity.

Restrictive Trade Practices

In response to the Arab boycott of Israel and several U.S. companies doing business with Israel, the Department of Commerce drafted regulations in 1975 entitled "Restrictive Trade Practices or Boycotts" (15 C.F.R. Part 369). The regulations are applicable to U.S. exporters and related service organizations, with the latter including banks.

The regulations prohibit exporters and banks from complying in any way with boycott requests that would cause discrimination against U.S. citizens or companies on the basis of race, color, religion, sex or national origin. Also, any such requests received by banks are to be reported to the Department of Commerce.

In the course of examining banks conducting foreign or international banking operations, it is important to ascertain whether or not the bank has received a request to participate or is participating in restrictive trade practices or boycotts. It is appropriate, therefore, that examiners be thoroughly familiar with the provisions of Part 369 of the regulations of the Department of Commerce.

The examiner should use sampling techniques or other tests of appropriate bank records and documents, to assess whether the bank has received requests to participate, has participated, or is participating in any manner in restrictive trade practices or boycotts in its international or foreign banking operations. To make such assessment, the examiner should carefully analyze supporting documents (especially letters of credit) of international transactions for any

indication of restrictive trade or boycott requests or provisions, express or implied. In addition, the examiner should, through discussions with bank management, assess whether any such stipulations or provisions were agreed to verbally.

If the facts reveal apparent restrictive trade practices or boycotts either required by others or agreed to by the bank, the relevant facts should be detailed on the Examiner's Comments and Conclusions schedule. Requests found, even though not agreed to by the bank, should be so reported. The examiner's comments should, if applicable, include:

1. The nature of the transaction giving rise to the request or practice;
2. A description of the restrictive trade practice or boycott requested or agreed to;
3. Whether it involves a violation of Part 369; and
4. An indication of the attitude of bank management with respect to the request or practice, including whether management has or will refrain from honoring such requests

or

discontinuing such practices.

Apparent violations of the prohibitions of Part 369 or its reporting requirements should be reported on the Violations of Laws and Regulations page under Group B. As noted, boycotts of countries friendly to the United States are not prohibited. Nevertheless, any request to a bank to participate in such a boycott, or any agreement by a bank to do so, should be detailed on the Examiner's Comments and Conclusions schedule.

The examiner is cautioned that known or willful violations of the regulations constitute criminal violations. In such case, the examiner should follow the procedures for reporting apparent criminal violations.

Foreign Corrupt Practices Act

Public disclosure of improper payments made by U.S. companies to foreign officials led Congress to enact the Foreign Corrupt Practices Act of 1977 (The Act). The Act is designed to prevent the use of corporate assets for corrupt purposes and applies to all U.S. companies including banks, bank holding companies and Edge Corporations.

The Act contains a number of provisions. First, companies subject to the jurisdiction of the Securities and Exchange Act of 1934 are required to maintain strict accounting standards and management control over their assets. The falsification of accounting records to conceal corrupt payments is, of course, prohibited. Second, the Act makes it a crime for a U.S. company, or individuals acting on behalf of a company, or individuals acting on behalf of a company, to bribe foreign officials or foreign political candidates or parties for the purpose of acquiring or retaining business. However, facilitating or so-called "grease" payments are not prohibited. Grease payments generally are those payments for expediting shipments through customs, securing required permits, or obtaining adequate police protection are all considered grease payments even though such payments may involve the payment of money for the proper performance of duties. The legislative history of the Act recognizes that, in some countries, payments to expedite or implement bureaucratic processing are customary practices.

The Act applies to all State nonmember insured banks, among other U.S. corporations, but does not apply directly to foreign subsidiaries. However, Congress has made it clear that any U.S. corporation which engages in bribery of foreign officials indirectly through any other person or entity, including a foreign subsidiary, would itself be liable under the Act.

All apparent violations of the Act are criminal in nature and should be reported following the procedures for reporting apparent criminal violations.

VIII. GLOSSARY OF INTERNATIONAL BANKING TERMINOLOGY

The following glossary of international banking terminology is recommended for use by and will be of invaluable assistance to examiners during examinations of banks' international operations and in completion required reports.

Acceptance -- A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the "acceptor", stamps or writes the word "accepted" on the face of the draft and

above his or her signature the place and date of payment. Once the draft is accepted it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A "bank acceptance" is a draft drawn on and accepted by a bank. A "trade acceptance" is a draft drawn by the seller of goods on the buyer, and accepted by the buyer.

Account Party -- Buyer/importer or applicant who arranges for the establishment of a letter of credit.

Advance -- (a) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (b) in international banking, an extension of credit usually recurring, when no instrument (other than a copy of the advice of an advance) is used as evidence of a specific indebtedness, except in special cases. A signed agreement must be on file in the department, stating the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but may be created to finance payments affected under a commercial letter of credit, to finance payments of collections or to refinance a maturing loan.

Advance Against Documents -- An advance made on the security of the documents covering a shipment.

Advised Letter of Credit -- An export letter of credit issued by a bank which requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of a correspondent bank. An advised credit creates no liability on the part of the advising bank

Advised Line -- An authorization for credit made known to the customer.

After Sight -- A draft where the time to maturity begins at its presentation or acceptance.

Agent Bank -- The bank which leads and documents a syndicated loan.

AID -- The Agency for International Development is a consolidation of most of the U.S.

Government's foreign economic activities. After the U.S. Government has authorized funds to be used by foreign governments for the purpose of purchasing commodities, services for certain projects, AID works in cooperation with the foreign governments in the utilization of these funds. The foreign governments, usually represented by a Central Bank, will then apply to AID for a specified sum for a specific purpose and designates a U.S. bank which will open the related letters of credit. Upon approval, AID then sends a letter of commitment to the designated U.S. bank. The commitment letter authorizes the U.S. bank to open letters of credit in favor of beneficiaries who will supply the goods and services needed by the foreign government. Upon negotiation and payment under its letters of credit, the U.S. bank obtains reimbursement from AID in accordance with AID's letter of commitment. The U.S. opening bank's letters of credit, therefore, if properly handled and documented, are, in essence, guaranteed by the U.S. Government.

Anticipation -- A deposit of funds to meet the payment of an acceptance prior to the maturity date. Should be applied to reduce customer's liability on acceptances.

Arbitrage -- Simultaneous buying and selling of foreign currencies, or securities and commodities, to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

At Sight -- A negotiable instrument payable upon presentation or demand. **Back-to-Back Letter of Credit -** An irrevocable letter of credit issued on the strength of another irrevocable letter of credit involving a related transaction. The latter credit is usually issued by a foreign bank with the beneficiary being a U.S. seller. The U.S. seller requests his bank of account to open a letter of credit in favor of the party who will ultimately sell the merchandise to him. As collateral, the U.S. seller deposits with his bank of account, the irrevocable credit in his favor opened by the foreign bank. The terms of the U.S. letter of credit must be identical with those of the backing credit except for the name of the beneficiary, the account party, the amount of the U.S. credit which

may be less than that of the backing credit but not more, and the expiration date.

Balance of Payments -- The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade -- The difference in money value between a country's merchandise imports and exports excluding capital transactions and services such as tourism. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Beneficiary -- The person or company in whose favor a letter of credit is opened or a draft is drawn.

Bill of Exchange -- An unconditional order written from one person (the drawer) to another person (the drawee) directing the latter to pay a certain sum of money at a fixed or future determinable date to the order of a third party. The terms "bill of exchange" and "draft" are generally used interchangeably.

Bill of Lading -- A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, a document of title, and a contract between the carrier and the shipper, covering the delivery of the merchandise to a certain point or to a designated person. It is issued in two primary forms: an "order bill of lading", which provides for the delivery of goods to a named person or to his or her order (designee) but only on proper endorsement and surrender of a bill of lading to the carrier or its agents; and a "straight bill of lading", which provides for delivery of the goods to the person designated by the bill of lading and no other.

BIS -- Bank for International Settlements. Acts as the agent for the European Monetary Agreement and promotes cooperation among European central bankers.

Blocked Exchange -- Exchange which cannot be

freely converted into other currencies.

Buyer's Option Contract -- When the buyer has the right to settle a forward contract at his or her option anytime within a specified period.

CACM -- Central American Common Market. An economic union composed of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

Cash Letter of Credit -- A letter addressed from one bank to a correspondent bank making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued. **CCC** -- The Commodity Credit Corporation is an agency of the U.S. Department of Agriculture, with its primary purpose being to promote the export of U.S. surplus agricultural commodities. Many of the letters of credit opened by U.S. banks are supported by purchase authorizations similar to AID letters of commitment. These authorizations enable the U.S. bank to obtain reimbursement from CCC for any drawings negotiated under this type of letter of credit. This particular type of CCC credit, however, is not to be confused with another CCC credit which is issued or confirmed by U.S. banks for account of a foreign government, central bank or importer. Under this latter form of credit, CCC is the beneficiary of the credit and not the account party. CCC therefore, does not reimburse the U.S. banks for any drawings made thereunder the U.S. bank must obtain reimbursement from its foreign customer for whom the credit was opened (account party of the letter of credit). Normal credit standards should be used in analyzing this latter type of credit, particularly since they often provide for terms of up to three years but are related to commodity transactions which are customarily financed on shorter terms.

Central Bank Intervention -- Direct action by a central bank to increase or decrease the supply of its currency to stabilize prices in the spot or forward market or move them in a desired direction. On occasion the announcement of an intention to intervene might achieve the desired results.

Certificate of Origin -- A document issued by the exporter certifying the place of origin of the

merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

Charter Party -- A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel setting forth the terms of the arrangement such as freight rate and ports involved in the trip contemplated.

C.I.F. -- Cost, Insurance, and Freight. A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Clean Draft -- A sight or time draft to which no other documents such as shipping documents, bills of lading, or insurances certificates are attached.

Clearing House Funds -- Funds used in settlement of a transaction available for use after one business day.

Closing a Position -- Covering open long or short positions by means of a spot operation and/or outright forward operation.

COMECON -- Council for Mutual Economic Aid. An economic alliance of the communist nations of eastern Europe. Members are Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Rumania and the U.S.S.R.

Confirmation -- Written communication to the counterparty in a foreign exchange transaction which recites all the relevant details agreed upon by telephone telex.

Confirmed Letter of Credit -- A letter of credit issued by a bank which bears the confirmation of the seller's (exporter's) bank. The "confirming" bank undertakes to honor the draft drawn in accordance with the terms of the letter of credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refused to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) will ask that the letter of credit be confirmed by another bank since the seller is not familiar with the foreign issuing bank and as a precaution against unfavorable exchange

regulations, foreign currency shortages, political upheavals, and similar situations that may arise in the foreign country.

Consular Documents -- Bills of lading, certificates of origin, or special forms of invoice which carry the official signature of the consul of the country of destination.

Consular Invoice -- Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States. Principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments and other statistical purposes.

Convertibility -- The ability of owners of one currency to exchange it for other foreign currencies (or gold) in the open market. Some countries permit portion of their currency to be convertible and will designate accounts that way, for example, "External" sterling and "Free" yen.

Cover -- The execution of an offsetting foreign exchange trade to close or eliminate an open exposure.

Cross Rate -- The ratio between the exchange rate of two foreign currencies in terms of a third currency.

Current Account Balance -- The difference in monetary terms between all goods, services and transfer payments entering and leaving a country. Includes trade, travel, military spending and other short-term financial flows. Short-term and long-term capital flows are excluded as they are included in the capital account balance. In most countries the balance of trade comprises the bulk of this indicator.

Date Draft -- A draft drawn to mature on a fixed date, irrespective of acceptance.

Deferred Payment Letter of Credit -- An instrument permitting the drawing of sight drafts and containing the stipulation that the drafts are not to be presented to the issuing bank until a specified length of time after documents have been presented and shipment made. Until presentation of documents, the bank's liability under this

arrangement is contingent in nature. When the beneficiary presents the documents and the bank acknowledges the receipt thereof or other performance by the beneficiary, the issuing bank is directly liable to the beneficiary as it would be in an acceptance transaction.

Demand Draft -- Draft payable immediately upon presentation to the drawee. Also called a "sight" or "presentation" draft.

Depth of the Market -- The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Devaluation -- An official act wherein the official of a country's currency is adjusted downward dollar, gold, Special Drawing Rights (IMF), or a currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDR or other currency.

Discount -- In foreign exchange, an adjustment to spot price made in arriving at a quote for future delivery. If a dealer quotes \$2.40 and \$2.45 (bid and asked) for sterling and the discounts for six months forward are .0030 and .0275, the forward quotes would be adjusted to \$2.3700 and \$2.4225. This discount usually represents differences in interest rates in the U.S. and Britain. However, in periods of crisis for a currency, the discount can represent the market anticipation of a lower price.

Documentary Credit -- A commercial letter of credit providing for payment by a bank to the named beneficiary, usually the seller of merchandise, against delivery of documents specified in the credit.

Documentary Draft -- A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

Documents -- Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates and commercial invoices. Certificates of origin and

consular invoices may also be required.

Documents Against Acceptance (D/A) -- Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

Documents Against Payment (D/A) -- Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

Dollar Exchange Acceptance -- Time draft drawn by Central Banks in specific foreign countries and accepted by banks in the U.S. for the purpose of furnishing foreign exchange. These instruments do not arise from specific commercial transactions, rather they are designed to alleviate shortages of dollar exchange for certain countries specified in a list published by the Federal Reserve System. It is anticipated that the acceptance will be liquidated subsequently from dollar funds acquired by the Central Bank. Limits are placed on initial maturity of drafts (three months). Member banks may not accept drafts in an amount exceeding 50% of paid-in and unimpaired capital and surplus.

Draft -- A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time to a third party (the payee). Drafts occasionally may be written to be non-negotiable, in that they will not meet all the requirements of the Uniform Negotiable Instruments Act. Drafts generally arise from a commercial transaction, whereby the seller makes an agreement with a buyer in advance for the transfer of goods. The draft may be made out by the seller (the drawer) ordering the buyer (the drawee) to pay his or her bank (the payee) for the goods purchased. It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. Drafts may be classified as to time element, such as sight or presentation drafts. A time draft is presented at sight, accepted, and then paid on the agreed upon date which may be 30, 60, 90 days or longer after presentation and acceptance.

Drawee -- The addressee of a draft, i.e., the person on whom the draft is drawn.

Drawer -- The issuer or signer of a draft.

ECE -- Economic Commission for Europe. A United Nations regional body comprising all European members of that organization plus Germany and the U.S.

ECLA -- Economic Commission for Latin America. A United Nations regional body comprising all Latin American members of that organization plus France, the Netherlands, the U.K. and the United States.

Edge Act -- An act passed December 24, 1919 as Section (25(a) of the Federal Reserve Act, with the title "Banking Corporations Authorized to do Foreign Banking Business". Edge corporations are chartered by the Board of Governors of the Federal Reserve System for 20 years with a minimum capital of \$2,000,000. Regulation K governs their operations. Their purpose is to aid in financing and stimulating foreign trade.

Eurocurrency -- The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London exchange markets.

Eurodollars -- Dollar deposit claims upon American banks deposited in banks located outside the United States, including foreign branches of American banks, although the funds do not physically leave the U.S. banks. Those claims in turn may be redeposited with banks or lent to companies, individuals or governments outside the United States.

Exchange Contracts -- Documents issued by foreign exchange dealers, by banks dealing in foreign exchange, and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions -- Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk -- The possibility of defaults on obligations by the imposition of

exchange control or restrictions.

Exchange Rates -- The price of a currency in terms of another.

Exchange Risk -- The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance -- A system to underwrite the collection of credits extended by exporters against various contingencies. In some countries only noncommercial risks can be insured. Public or private organizations, or both, may offer export credit insurance in different countries.

Export-Import Bank -- Established in 1934; all of its shares are held by the U.S. Treasury. Purpose is to provide intermediate and long-term nonrecourse financing for U.S. exports when such facilities are not available from commercial banks.

Export Letter of Credit -- A letter of credit opened by another bank or branch (usually foreign), arising from the financing of exports from the foreign country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and if advised, it becomes an advised (unconfirmed) letter of credit.

Exposure (or Net Exposure) -- The existence of risk of gain or loss because of the ownership of an asset, or the net amount of various assets and liabilities, denominated in a foreign currency.

F.A.S. -- Free Alongside Ship (vessel). A term of a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

F.O.B. -- Free On Board (vessel). A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Fixed Rate of Exchange -- A rate of exchange set by a foreign government relative to the dollar, gold, another currency or perhaps SDR's. It remains in effect as long as that government is

willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange -- A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, SDR's or another currency when the rate fluctuates beyond certain parameters.

Floating Rate -- A rate of exchange that is completely determined by market forces with no floor ceiling vis-a-vis the dollar, gold, SDR's or any other currency.

Foreign Exchange -- Simply stated, foreign money. In addition to currency and coin, foreign exchange includes bank assets and liabilities payable in foreign currencies. Also, the trading in or exchange of a foreign currency in relation to another currency. Rates of exchange are established and quoted for various foreign currencies based on the demand, supply and stability of the currency. Foreign exchange is the means by which values are established for foreign merchandise, thus permitting the exchange of commodities between countries.

Foreign Exchange Market -- Meetings or systematic communications by telephone or telex between foreign exchange dealers and brokers to transact wholesale business in foreign exchange and in Eurocurrencies.

Foreign Exchange Reserves (Official) -- The reserves maintained by a central bank which usually include gold and easily traded currencies of major industrial nations.

Forward Book -- Total of all forward contracts for a given currency or all currencies.

Forward Exchange Position -- The long or short position in the forward market, as compared to spot dealing. The suggestion of such a position usually require is further explanation as forward contracts eventually become due in short periods of time as do spot contracts.

Forward-Forward Dealing -- The simultaneous purchase and sale of a currency for different forward dates.

Forward Purchase -- An outright purchase of a

forward contract.

Forward Rates -- The actual rates at which foreign exchange for future delivery are quoted, bought and sold.

Future (or Forward) Exchange Contract -- A contract usually between a bank and its customer for the purchase or sale of foreign exchange at a fixed rate with delivery at a specified future time. A future contract is due later than a spot contract which is settled in one to ten days depending on the bank or market. Future exchange contracts are generally used by the customer to avoid the risk of fluctuations in rates of foreign exchange which he or she may need or may be due in the future.

Green Clause Letter of Credit -- Same as the red clause letter of credit, except that under the green ink clause, advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

Guidance Line -- An authorization, unknown to the customer, or a line of credit. If communicated to the customer, the guidance line becomes a commitment.

Hedging -- A transaction used by dealers in foreign exchange, commodities and securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset, or it may merely last one, three, six or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. (Also referred to as "covering".)

IMF -- International Monetary Fund. A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for exchange policy, promotes stable exchange policy, promotes stable exchange rates among member nations, and makes short-term advances and standby credits to members

experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

Import Letter of Credit -- A letter of credit issued by the bank on behalf of a local customer who is importing merchandise into the country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Intra-Day Position -- The size of spot or forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the day. Also called "daylight" limits.

Issuing Bank -- Also known as the opening bank. The buyer's bank which issues a letter of credit.

LAFTA -- Latin America Free Trade Association. An economic union comprising Argentina, Brazil, Columbia, Ecuador, Mexico, Paraguay, Peru, and Uruguay.

LIBOR -- London Interbank Offered Rate. The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

Limits -- Maximum line amounts by bank name with other banks for forward exchange transactions. Eurocurrency transactions, and payments arising from foreign exchange transactions on the same day.

Long Position -- An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sales contracts) in the same currency. A dealer's position when net purchases and sales result in a net-purchased position.

Manager of Syndicate -- The bank which solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

Marine Insurance Policy -- A contract of indemnity by which an insurance company undertakes to refund to the insured the amount of loss arising from specified marine casualties. Marine insurance is more extensive than other types, because it may provide not merely for losses arising from fire, but also from piracy, wreck and most injuries sustained at sea.

Matched -- A forward purchase is matched when

it is offset by a forward sale for the same date, or vice versa. However, as a practical necessity, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semi-monthly period.

Maturity Date -- The settlement date or delivery date for a forward contract.

Maturity Gap (Gap) -- Mismatched asset and liability maturities creating days or periods of uneven cash inflows and outflows. A substantial inflow of a particular currency over a prolonged period may result in excess idle funds for which no investment or sale has been arranged. This could mean a loss of income on the idle funds for that period and/or of the amount by which the value of that currency is expected to appreciate or depreciate. Conversely, substantial outflows prior to the maturities of offsetting assets may necessitate purchasing or borrowing the required currency for that period (gap) at substantially higher rates. Thus, the bank is exposed to the risk of rate changes between the time the gap was created and the date it is actually closed.

Multi-Currency Line -- A line of credit giving the borrower the option of using any readily available major currency.

Negotiation Letter of Credit -- A credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers or bona fide holders.

Net Position -- A bank has a position in a foreign currency when its assets, including future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net "long" position and liabilities in excess of assets result in a net "short" position. A long net position in a currency which is depreciating results in a loss because, with each day, that position (asset) is convertible into fewer units of local currency. A short position in a currency which is appreciating represents a loss because, with each day, satisfaction of that position (liability) costs more units of local currency.

Nostro Accounts -- Demand accounts of banks with their correspondents in foreign countries of the latter's currencies. Such accounts are used to

make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign exchange contracts. Also called due from foreign bank - demand accounts, our balances with them, or due from balances.

Odd Dates -- Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Off-Shore Dollars -- Same as Eurodollars, but encompassing such deposits held in banks and branches anywhere outside of the United States, including Europe.

Option Contracts -- Foreign exchange transactions wherein one of the parties has the right to settle all or part of the contract at an agreed time prior to maturity at the price shown in the contract. Also, called optional forward contracts.

Outright -- Forward exchange bought and sold independently from a simultaneous sale or purchase spot exchange.

Political Risk -- Political changes or trends often accompanied by shifts in economic policy which may affect the availability of foreign exchange to finance private and public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions as well as the possibilities of war, revolution or expropriation in each country with which the bank transacts business, regardless of the actual currency(s) involved.

Position -- The net or overall balance of a foreign currency taking into account all assets and liabilities, direct and indirect, denominated in a particular currency.

Position Limits -- The maximum net debit or credit foreign currency balance either during the day (daylight limits) or at close of business (overnight limits) as stipulated by bank management.

Position Sheet -- Also known as the position book. A listing of all foreign exchange transactions creating a position. Enables the

senior dealer to monitor the open position in particular currency and the overall open position in all currencies.

Premium -- The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote \$2.00 and \$2.05 (bid and asked) for sterling and the premiums for six months forward are .0275 and .0300, the forward quotes would be adjusted to \$2.0275 and \$2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Red Clause Letter of Credit -- Ordinarily, the terms of a letter of credit, as specified by the buyer, will not permit the beneficiary to obtain payment in advance of shipping the merchandise. In certain circumstances, the buyer may wish to extend the benefits of a letter of credit to assist the seller in procuring or obtaining the goods (closely akin to an unsecured working capital advance). Traditionally, this provision is inserted on the face of a regular letter of credit in a clause written in red ink. The beneficiary is authorized to obtain preshipment financing against his undertaking to deliver the shipping documents as specified within the expiration date. These instruments take two forms. One authorizes a foreign bank to provide financing in foreign funds to the beneficiary. The foreign bank is paid for advances and interest thereon by drawing drafts on the issuing bank. The other type authorizes the beneficiary to draw drafts on the issuing bank.

Reimbursement Letter of Credit -- A letter of credit issued by one bank and payable at a second bank which, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are almost always expressed in a currency other than that of the buyer (issuing bank) or the seller, and because of wide acceptability many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Revaluation -- An official act wherein the official parity of a currency is adjusted relative to the dollar, gold, SDR's or another currency, resulting

in less revalued units relative to those currencies. Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

Revolving Letter of Credit -- A letter of credit issued for a specific amount which renews itself for the same amount over a given period. Usually the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Risk, Credit -- The possibility that the buyer or seller of foreign exchange may be unable to meet his or her obligation on maturity.

Risk, Delivery -- The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

Risk, Exchange -- The possibility of a loss on a covered position as a result of an appreciation or depreciation of the foreign currency.

Risk, Forward Exchange -- The possibility of a loss on a covered position as a result of a change in the swap margin.

Same Day Funds -- The use of Federal funds, or the equivalent, in the settlement of a transaction which will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

Seller's Option Contract -- When the seller has the right to settle a forward contract at his or her option anytime within a specified period.

Short Position -- An excess of liabilities (and/or forward sales contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net purchases and sales in a net-sold or oversold position.

Sight Draft -- A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace".

Soft Loans -- Loans with exceptionally lenient terms for repayment such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Spot Exchange (or Spot Currency) -- Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one or two business days after the conclusion of the deal. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate reevaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity.

Spot Transaction -- A transaction for spot exchange (or currency).

Spread -- The discrepancy between buying and selling foreign exchange rates and between support points or arbitrage support points.

Standby Letter of Credit -- Any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer: to repay money borrowed by or advanced to or for the account party; to make payment on account of any indebtedness undertaken by the account party; or to make payment on account of any default by the account party in the performance of an obligation.

Straight Letter of Credit -- A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Swap -- The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another; merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures.

Swap Cost or Profit -- The cost or profit related to the temporary movement of funds into another currency and back again in a "swap" transaction. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign exchange trader cannot be determined if swap profits or costs are charged

to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Syndicate Participation -- Usually, a large credit put together by a group of lenders with each advancing a portion of the required funds. It differs from a participation loan because the banks participate at the outset and are known to the borrower.

Tenor -- Designation of payment of a draft as being due at sight, a given number of days after sight or a given number of days after the date of the draft.

Terms of Trade -- Relative price levels of goods exported and imported by a country.

Time Draft -- A draft drawn to mature at a fixed time after presentation or acceptance, e.g., a given number of days after sight (acceptance) or a given number of days after the date of the draft.

Tranche -- A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

Transferable Letter of Credit -- A credit under which the beneficiary has the right to give instructions to the bank called upon to affect payment or acceptance, or to any bank entitled to affect negotiation, to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part.

Traveler's Letter of Credit -- A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Trust Receipt -- Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the bank releasing it, although the

bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before paying the issuing bank.

Unmatched -- A forward purchase is unmatched when a forward sale for the same date has not been executed, or vice versa.

Usance -- The period of time between presentation of a draft and its maturity.

Value Date -- The date on which foreign exchange bought and sold must be delivered and on which the price for them in local currency must be paid.

Vostro Account -- Used by a bank to describe a demand account maintained with it by a bank in a foreign country. The nostro account of the other bank.

Warehouse Receipt -- An instrument which lists, and is a receipt for goods or commodities deposited in the warehouse which issues the receipt. Such receipts may be negotiable or non-negotiable warehouse receipt is made to the "bearer" and a non-negotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: The delivery of goods may be allowed only against cash payment or substitution of similar collateral. Some or all of the goods may be released against trust receipt without payment. A warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt is a bonded warehouseman. The bank must have protected assurances for the genuineness of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.